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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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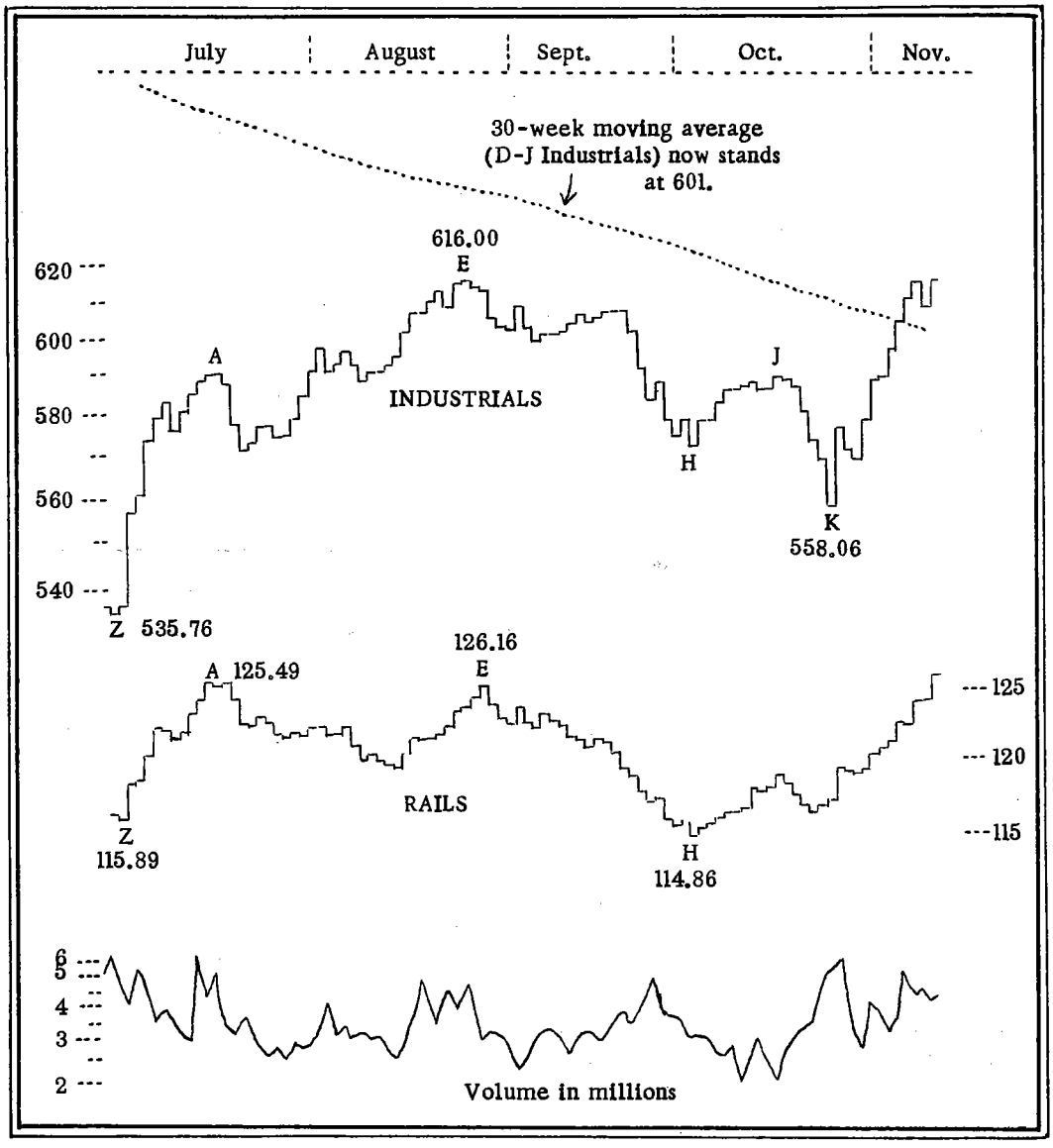
THE MARKET The almost vertical advance from point Z (on chart) to point A (June-July) was universally greeted as a "normal response" to the worst spring crash of modern times. The more recent vertical advance which began on October 23 (K), however, has caused a great many analysts to tread the "new bull market" path.

On Friday (November 9) the two Averages penetrated their respective 1962 post-crash recovery highs (Industrials 616.00, Rails 125.49). The joint penetrations provide a "mechanical" bull signal according to Dow's Theory. As far as this writer is concerned, the bull signal of November 9 is suspect.

As explained in recent Letters: (1) the bear market did not go through the three classic phases; (2) the bear market was too short in point of time; (3) "values" (judged by historical standards) did not appear; (4) psychology never approached the state of "hopelessness" which accompanies true bear market bottoms. Moreover, (5) the relationship of the Industrial Average and the A-D ratio assumed a major bearish pattern, and I will discuss this in detail later in this Letter.

The rally from K has set off a barrage of phone calls and letters to this office — "Is it a new bull market?" "Should I cover my shorts?" "Should I buy?" In answer I have always stressed mental "stop-buys" for shorts. Those who did not cover during the rally are asking me what they should do now. In effect, they are insisting that I predict the daily trend. It cannot be done, and I refuse to play the part of a "quack." As to whether one should buy, and as to whether it is a new bull market, those questions (as far as the true investor is concerned) are one and the same, and I will attempt to answer them now.



The great profits in the market have been made by individuals who purchased substantial amounts of stocks at or around the beginning of a primary bull swing. If I am not satisfied that we are (1) near a bear market bottom, or (2) near a bull market reaction bottom — then I prefer not to recommend the bull side of the market to my subscribers. Occasionally, I do feel that long or short positions are in order for traders, and at such times I say so.

A subscriber writes: "I have wondered why in Letters 184, 186,

187, 189, 194, and 199 you repeatedly called attention to the violent post-crash correction of 1929-1930. The market rise of the past few weeks has caused me to stop wondering." (R. T., Stamford Conn.).

The violent action of the market since October 23 has suggested that my repeated references to the great 1930 recovery may not have been wasted. The rise which followed the November, 1929 low of 198.69 recovered 52% of all the preceding (1929) bear market losses for Industrials (or 62% of the Industrial losses sustained on the preceding secondary primary bear swing). A comparable recovery could now take the Industrial Average to the 638-652 level. Such a continuation of the current recovery would add a possible 22 to 46 points to the recent August 23 (616.00) Industrial peak, although it is obvious that the majority of issues (as represented by the A-D ratio) have been lagging on the rise.

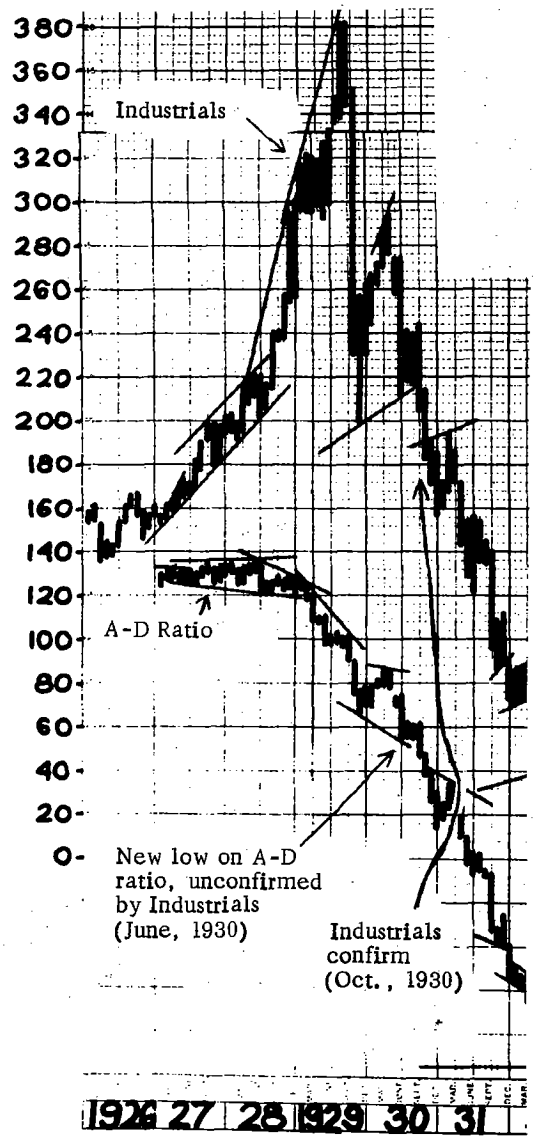
AN IMPORTANT STUDY My studies of the relationship between the Industrial Average and the A-D ratio show that the A-D ratio is a more reliable indicator of tidal or primary action than the Industrial Average. Since the A-D ratio takes into account the rising or declining tendency of all stocks on the Exchange, this is not difficult to understand. Furthermore, I have noted that in past history (going back to 1932), whenever a primary bear market ended and a new primary bull market began — from that point on, the A-D ratio never broke below its bear market low. Although there have been cases in which Industrials later broke below a final low established by breadth, there has never been a case in which a true primary bottom (on Industrials) was followed by a subsequent new low on the A-D ratio (see Letter 199).

I have included charts (monthly high-low ranges) which illustrate two historically important examples of the breadth-price relationship. Each or both of these examples may be applicable today. Following the A-D ratio peak established in mid-1928, the Industrial Averages surged to a record high of 381 in September, 1929. The persistent refusal by the A-D ratio to confirm the 1929 Industrial high provided the technical basis for the 1929 crash. Both breadth and the Average broke to lows in November 1929 (Industrials 198). An explosive recovery rally took Industrials to 294 in April, 1930. Following this the two indicators turned down, and in June the A-D ratio broke to a new bear market low. This low was not confirmed by Industrials (Industrials halted at 211 — 13 points above the 1929 low). A second recovery ensued, and by September, 1930, Industrials had rallied to 245. But the low in breadth was fated (as it usually is) to be confirmed by Industrials. In early October, 1930, Industrials broke below their 1929 low of 198 — and breadth and price were once again "in gear."

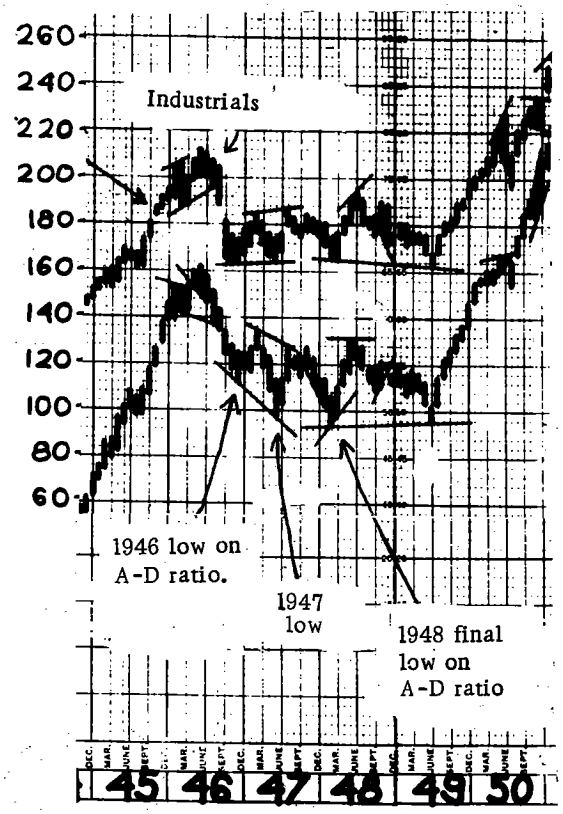
A second most interesting breadth-price series occurred between 1946 and 1949 (see chart). The 1946 crash took both breadth and the Industrial Average to bear market lows (Industrials 163.12). A recovery carried into 1947, following which the market again turned down. In May, 1947, Industrials dropped to 163.21 (8¢ above their 1946 low), but breadth sank to a new bear market low. Another recovery developed, but by mid-1947 this rise petered out, and again the market declined. By March, 1948, Industrials had fallen to 165.39 (still above their 1946 low), but breadth fell to a third consecutive bear market low!

A final recovery got under way, and this time Industrials rose to 193 (June, 1948), but the March, 1948, low in breadth drew the market down like a magnet. The final decline started on June 15, 1948, and it continued until June 13, 1949. But here the extraordinary occurred. On June 13, 1949, Industrials broke to a three-year low of 161.60, thus penetrating (by two points) their 1946-48 range and confirming the new low set in breadth in 1948. Even more dramatic, on the decline to the June 13, 1949 low, the A-D ratio held above its 1948 low. This extremely bullish turn of events (the Industrial Average was finally in gear with breadth, but breadth would not break below its 1948 low) gave birth to the great bull market of the 1950's.

How does all this apply to the current situation? I believe it applies as follows: The June 26, 1962, Industrial low of 535.76 was followed by an important new low on the A-D ratio in October, 1962. The fact that breadth broke to a new low after a low established by the Industrial Average suggests that the bear market is not over. The history of the breadth-price relationship shows that following the final low of a bear market, the A-D ratio turns up — and stays above its bear market low for the duration of the new bull market. Moreover, history demonstrates that when the A-D ratio breaks to a new bear market low — unconfirmed by the Industrial Average — then regardless of the extent or duration of the rally which may follow, one can expect an eventual decline which will serve to restore harmony between breadth and price. That harmony can only be restored by a new Industrial low which serves to confirm the preceding low on the A-D ratio.



The persistent refusal by Industrials to confirm a new low in breadth has led, on occasion, to important rallies. This is the situation as of this writing. Such technical recoveries may be violent (as in 1930) or dragging (as in 1946-47). But in each instance, the big picture has always been an eventual decline and confirmation (by Industrials) of the new low on the A-D ratio.



In those cases in which Industrials broke to a new bear market low unconfirmed by breadth, however, it may be said that the breadth-price relationship was strongly bullish (usually in the primary sense). As explained previously, this is exactly what occurred in June, 1949.

1962 IN THE LIGHT OF HISTORY The market action since June 26, 1962, is developing along lines established during every post-crash recovery since 1929. The breadth-price relationship and the "bull signal" of November 9 are suggestive of things to come.

From the 1929 bull market peak of 381.17, Industrials crashed to a late-1929 low of 198.69. During the next eleven months Industrials rallied to 294.07 (April, 1930), declined to 211.84 (June, 1930), rallied to 245.07 (September, 1930), then collapsed through the 1929 low as the great bear market was resumed.

From the 1937 bull market peak of 194.40, Industrials crashed to a 1938 low of 98.95. During the next three years (1938-41) Industrials fluctuated in a trading range between 158.51 and the 1938 low. The range was finally broken on the downside, and Industrials "bottomed out" at the famous 92.92 low closing of April 28, 1942.

From the 1946 bull market peak of 212.50, Industrials crashed to a 1946 low of 163.12. During the next three years (1946-48) Industrials fluctuated in a trading range between 193.16 and the 1946 low. The range was finally broken on the downside, and Industrials bottomed out at 161.60 on June 13, 1949.

Although (in retrospect) we know that the periods following the lows of 1929, 1937 and 1946 were (at best) extended "trading areas", it is also interesting to note that these periods contained four "mechanical" bull market signals. Mechanical bull signals were given in February, 1930, June, 1938, July, 1939 and May, 1948. The Industrial appreciation from the point of the "new bull market" confirmations on each of these dates was respectively 12%, 25%, 8% and 4%. In no instance was the preceding major bull market top bettered by either Average.

Following each of these "bull signals", the length of time which elapsed before the "new bull market" terminated was as follows: February, 1930 to April, 1930 (two months): June, 1938 to November, 1938 (five months): July, 1939 to September, 1939 (two months): May 15, 1948 to June 15, 1948 (one month).

With the above material in mind, the action of the market during and following the 1962 crash suggests to the writer that one of the following two patterns will be repeated: (1) Industrials will fluctuate (for a few years) within a trading range of perhaps 630-70 on the upside and the June, 1962, low (535.76) on the downside. During this period the A-D ratio will sink to successive new lows, eventually to be confirmed by an Industrial decline below 535.76. This will be the final downward leg leading to a major bear market bottom. (2) Following a possible further Industrial recovery to perhaps 630-70, the bear market will be resumed after the pattern of 1930. Eleven months elapsed between the November, 1929 low, and the 1930 penetration (in October, 1930) of the 1929 low. If the same time schedule holds, we might expect new bear market lows during the first quarter of 1963.

CONCLUSION: The post-crash periods of the past were each marked by deceptive "bull signals", lagging breadth and disappointments for long-term investors. It is my opinion that those buyers who are now hoping for a major new bull market will be disappointed again. Profits were hard to come by during 1937-42 and 1946-49. They were certainly hard to garner during 1930.

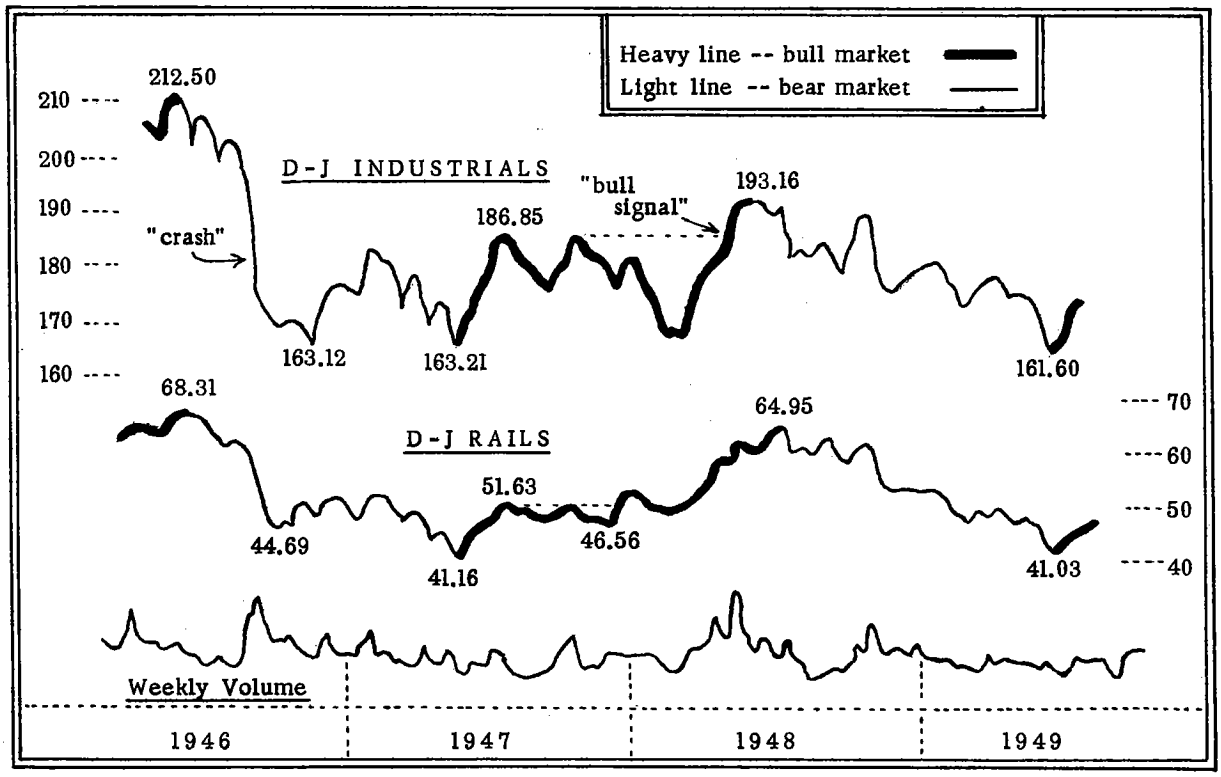
TACTICS Judging from letters and calls received, many subscribers are willing to "come in" on the basis of trading commitments on the bull side. Others feel that this is perhaps a "more valid" bull signal than those mentioned in previous paragraphs. I have no firm objection to either argument (assuming these subscribers have read the preceding paragraphs and understand the risks involved).

As to immediate commitments, the market is now in a fairly overbought condition. If it surges upward from here, it will undoubtedly be subject (assuming it does not completely "top out") to a protracted, sinking consolidation movement. On the other hand, if the market now consolidates and/or declines, we will have a better chance to gauge its strength and make purchases. In either case, I feel that trading commitments can be held in abeyance. I believe that odds heavily favor a more advantageous buying period during the next month or so than at present.

* * * * *

The chart below illustrates the difficult and deceptive post-crash trading range of 1946-49. Note the "bull signal" given in May, 1948, when Industrials bettered their 186.85 peak established in 1947 (Rails have already bettered their 1947 peak). A month later the "baby bull market" of 1947-48 ended. Those who bought on the May, 1948, bull signal saw the Industrials rise 7 points before "topping out" (in June, 1948). Within a few months of the bull signal, buyers were losing money.

To have made money during this period, one would have had to buy at the second (1947) bottom following the 1946 crash and sold within a month of the May, 1948 bull market signal!



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LATE NOTES (Written Monday, November 12, 11 A.M., N.Y. time). At this writing Industrials are up over 4 points (following the bull market signal). If the advance continues, the market will get into a progressively more "overbought" condition. The instances in the past where one could have made purchases profitably on the top of a 62 point rise are few and far between. It is well to remember that every market movement, whether minor, secondary or primary is subject to a normal 1/3 to 2/3 correction. The current rise will probably be no exception. I feel that discussions of individual stocks will more profitably be held over for the next Letter.